



April 28, 2014

**Via Email (reg-comm@fca.gov)**

Ms. Laurie A. Rea  
Director  
Office of Secondary Market Oversight  
Farm Credit Administration  
1501 Farm Credit Drive  
McLean, VA 22102-5090

**Re: Advance Notice of Proposed Rulemaking—Federal Agricultural Mortgage Corporation Governance; Farmer Mac Corporate Governance and Standards of Conduct (12 CFR Part 651, RIN 3052-AC89, February 25, 2014)**

Dear Ms. Rea:

This letter is submitted by CoBank, ACB; CoBank, FCB; and the Farm Credit Bank of Texas in response to the above-captioned advance notice of proposed rulemaking published by the Farm Credit Administration (“FCA”). As you know, we are each Class B shareholders of the Federal Agricultural Mortgage Corporation (“Farmer Mac”) and, as such, particularly interested in the subject matter of this proposed rulemaking.

We commend the FCA for seeking comment as it considers proposing regulatory changes to Farmer Mac’s corporate governance and standards of conduct. Farmer Mac’s unique statutory governance structure complicates any FCA rulemaking in this area, especially as it concerns the delicate balance struck by Congress to ensure Farmer Mac’s board of directors is representative of three separate and distinct constituencies: (1) holders of Farmer Mac’s Class A voting common stock that are “insurance companies, banks, or other financial institutions or entities,” (2) holders of Farmer Mac’s Class B voting common stock that are “Farm Credit System institutions,” and (3) the general American public.<sup>1</sup> As a threshold requirement for any regulation in this area, FCA must acknowledge and respect the rights under the Agricultural Credit Act of 1987 provided to Class A and Class B shareholders, as a group, to have directors that represent their specific interests be elected to, and serve on, the Farmer Mac board.

As explained in more detail below, we are concerned that FCA rulemaking in this area may inadvertently have the effect of reducing the rights of Class A and Class B shareholders on the Farmer Mac board. Importantly, the generalized notion that Farmer Mac directors owe fiduciary duties to all stakeholders of Farmer Mac should not in any way override or contravene the clear director representation rights of Class A and Class B shareholders. In forming Farmer Mac, Congress

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<sup>1</sup> See 12 U.S.C. § 2279aa-2(b)(2).

purposefully designed the governance structure to be representative in nature. It is imperative, from a public policy perspective, that FCA regulation permit this representative form of governance to function unimpeded. This representative structure ensures Farmer Mac operates in a manner consistent with its mission and provides value to the intended beneficiaries of its Government Sponsored Enterprise (“GSE”) status, which are America’s farmers and ranchers and certain other rural borrowers.

Congress purposefully created Farmer Mac’s unique board structure, in part, to attempt to mitigate the basic conflict that arises between the interests of Farmer Mac as a publicly traded company and its public policy mission as a GSE. As often heard during Farmer Mac earnings calls, Farmer Mac’s Class C shareholders consistently ask for increased leverage, dividend payouts, and stock buybacks, all with the aim of boosting their returns. And recently, Farmer Mac appears to be heeding these requests, particularly as it relates to increased dividend payouts. This drive to generate returns and assume risk for investors in Farmer Mac’s publicly traded stock can be at odds with its public policy mission as well as safety and soundness considerations. In order to most effectively serve its mission, Farmer Mac directors must often ensure that the company retain earnings, build capital to reduce leverage, and, if needed to ensure financial strength, constrain growth, particularly during good economic times. Many of these decisions, all made in the interest of protecting the long-term mission and safety and soundness of Farmer Mac to ensure credit availability to particular segments of the rural economy, would be contrary to the short-term interests of investors looking to maximize return on their investment in Farmer Mac stock.

Congress made a clear policy decision in structuring the board of Farmer Mac as representative of the institution’s two primary types of users along with representatives of the public interest while denying to the Class C shareholders any voice in its governance. FCA’s rules and oversight of Farmer Mac should reinforce this policy decision, not undermine it.

For example, we believe Farmer Mac’s practice of compensating its directors with Class C stock options undermines the board’s fiduciary duties to Farmer Mac’s Class A and Class B shareholders. Awarding Class C stock to Farmer Mac’s Class A and Class B directors erodes the separation of interests intended by Congress, and may provide unintended incentives for directors as they might weigh the gains they might receive from their Class C stock options against the fiduciary duties they owe to the Class A and Class B shareholders that they represent.<sup>2</sup> Fortunately, FCA can easily resolve this issue by prohibiting the awarding of stock options and, ultimately, requiring the elimination of Class C stock altogether over time.<sup>3</sup> We believe this would enhance Farmer Mac’s financial discipline, transparency, and director accountability, while also being consistent with its fundamental approach to meeting capital needs as seen over recent years through the issuance of preferred stock. Finally, this would align Farmer Mac with evolving best practices to prevent excessive exposure to loss by the U.S. taxpayer which was an unfortunate consequence of this hybrid form of GSE ownership in the housing market.

In addition, the listing requirements for Farmer Mac’s publicly traded stock unnecessarily complicate its corporate governance. These requirements often include expectations for governance and

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<sup>2</sup> The issue is not limited solely to Class A and Class B directors. The five Presidentially appointed directors are similarly incentivized to balance the gains they might receive from their Class C stock options and their obligation to represent the interests of the general public on the Farmer Mac board.

<sup>3</sup> Conceptually, Farmer Mac could replace Class C stock with Class A, Class B, and/or perpetual preferred stock to meet its capitalization needs. In the case of perpetual preferred stock, such stock should be priced and traded based on Farmer Mac’s true financial capacity to perform and its risk profile.

director performance that are inherently inconsistent with Farmer Mac's governance structure as established by Congress. Companies with publicly traded stock are fundamentally different in structure and purpose than those without. Typically, a shareholder's influence over the board of a publicly traded company is directly related to the number of shares held, resulting in the need for requirements to protect against possible abuses. Often, large shareholders vote themselves or their representatives onto the board, which gives rise to the need to ensure that they act in the interest of all shareholders. These concerns are simply not applicable to Farmer Mac. Farmer Mac has a fundamentally different governance structure than the typical publicly traded company. Farmer Mac's board consists of five representatives elected by the Class A shareholders, five directors elected by the Class B shareholders and five directors appointed by the President of the United States. For this reason, listing requirements designed for the typical publicly traded company whose entire board is elected by one class of common shareholders are not directly applicable or appropriate for Farmer Mac. From our perspective, FCA is in the unique position, and has the obligation, to ensure, through regulation, that Farmer Mac adheres to the governance requirements established by Congress and eliminates any confusion relating to the need for the Farmer Mac board to---first and foremost---abide by the structure and purpose established by Congress and embodied in Farmer Mac's congressionally mandated charter.

For example, Farmer Mac has applied the independence standards of the New York Stock Exchange (NYSE) in such a manner as to weaken the representative form of governance established by Congress when it created the structure of the Farmer Mac board. The NYSE requires that the majority of directors be independent, meaning that they have no material relationship with the listed company.<sup>4</sup> This requirement, designed to lessen the possibility of conflicts of interest, is not appropriate for Farmer Mac as it undermines the representative form of governance as intended by Congress. This requirement (promulgated by the NYSE, a self-regulatory organization) cannot and should not override Farmer Mac's statutory charter and the clear intent of Congress in establishing Farmer Mac's board of directors embodied therein.

Therefore, it is appropriate and necessary for FCA to establish through regulation that Class A and Class B directors are duty bound to represent the interest of their respective Class and clarify that this duty is not a conflict of interest. This approach would ensure Farmer Mac's governance structure functions as intended under the Agricultural Credit Act of 1987.

With these general principles concerning Farmer Mac's corporate governance in mind, we now turn to the more specific comments we wish to provide FCA with respect to Questions 2 and 6–14 in the FCA's above-mentioned Advance Notice of Proposed Rulemaking.

**(2) Should FCA regulations authorize bylaw provisions for the automatic removal of an elected director found to have violated conflicts of interest prohibitions? If so, what types of prohibited actions related to conflicts of interest should warrant removal?**

No. We do not believe FCA regulations should authorize Farmer Mac to adopt bylaw provisions for the automatic removal of an elected director found to have violated conflict of interest prohibitions.

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<sup>4</sup> NYSE Listed Company Manual §§303A.01 and 303A.02 (available at <http://nysemanual.nyse.com>).

Assuming arguendo that FCA has the authority to grant such a right to Farmer Mac<sup>5</sup>, it would be against clear Congressional intent to do so.

Farmer Mac was created by Congress, pursuant to the Agricultural Credit Act of 1987, as a shareholder owned GSE, with the goal of facilitating a secondary market in agricultural real estate and rural home loans originated by Farm Credit institutions and other lenders. The Agricultural Credit Act of 1987 mandated the specific composition of the board of directors of Farmer Mac, which has not changed since its establishment, although the goal of Farmer Mac has changed. Specifically, the composition of the board of directors includes (1) five directors elected by holders of Farmer Mac's Class A voting common stock that are "insurance companies, banks, or other financial institutions or entities," (2) five directors elected by holders of Farmer Mac's Class B voting common stock that are "Farm Credit System institutions," and (3) five directors appointed by the President of the United States, with the advice and consent of the United States Senate, and subject to certain additional criteria.<sup>6</sup> Under this structure, when a Class A or Class B director position becomes vacant, the remainder of the Farmer Mac board has the sole power to appoint a replacement director from among persons eligible to hold such position.<sup>7</sup>

If Farmer Mac adopted bylaw provisions for the automatic removal of elected Class A and Class B directors based upon the board's determination that the director had violated Farmer Mac's conflicts of interest policy, the carefully constructed balance struck by Congress regarding Farmer Mac's board representation would be upset. The automatic removal of an elected director and replacement of such person by the Farmer Mac board would take away power from Class A and Class B shareholders and put it in the hands of the full Farmer Mac board (including the five appointed directors).

This transfer of power away from Class A and Class B shareholders would be inconsistent with Congress' legislative intent. For example, when describing the legislation creating Farmer Mac (and specifically the role of the three types of directors on the Farmer Mac board), Representative Bereuter noted that "[t]o protect the interests of both the Farm Credit System and commercial lenders, the permanent Farmer Mac board provides for equal representation on the board by the Farm Credit System, commercial lenders and the public sector."<sup>8</sup> The "equal representation" on the Farmer Mac board provided to Class A and Class B shareholders was provided with a particular Congressional purpose in mind—namely, to protect the interests of the Farm Credit System and other financial institutions by bringing their independent perspective and judgment to the Farmer Mac board. Subsequent legislation has not altered this clearly articulated, and fundamental, Congressional intent.

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<sup>5</sup> FCA's authority to authorize Farmer Mac to adopt bylaw provisions for the automatic removal of elected directors is open to question. Congress has not explicitly granted such authority to FCA. More importantly, the statute authorizing Farmer Mac contains one—and only one—trigger that results in the automatic removal of a Class A or Class B director: the director ceasing to be "representative" of his or her elective constituency. Given that Congress legislated one circumstance in which an elected director is automatically removed from his or her position, principles of statutory interpretation weigh strongly against implying others.

<sup>6</sup> 12 U.S.C. § 2279aa-2(b)(2).

<sup>7</sup> 12 U.S.C. § 2279aa-2(b)(4).

<sup>8</sup> 133 Cong. Rec. 36,458 (Dec. 18, 1987).

Concerns regarding a transfer of power away from Class A and Class B shareholders to an incumbent Farmer Mac board are particularly acute in the context of Farmer Mac's conflict of interest prohibitions, for two reasons: (1) the enormous power and discretion already wielded by the Farmer Mac board in this area, and (2) the difficulty of determining when a conflict of interest has occurred in the context of Class A and Class B directors serving on the Farmer Mac board.

Pursuant to FCA regulations, the Farmer Mac board has been delegated the power to draft and enforce its own conflict of interest policy.<sup>9</sup> This broad grant of authority places enormous power in the hands of the Farmer Mac board to determine the definition of a "conflict of interest" and whether a director on the Farmer Mac board has such a "conflict of interest". As set forth in the most recent Farmer Mac Code of Business Conduct and Ethics (amended and reaffirmed as of December 4, 2013) (the "Farmer Mac Code"), the Corporate Governance Committee of the board has the power, among other remedies, to "restrict the distribution of certain sensitive information to a director" with a material conflict of interest.<sup>10</sup> A director with a material conflict of interest also may not "participate in any discussion or deliberation of, or any vote on, any question, issue, decision, or transaction" related thereto.<sup>11</sup> Providing Farmer Mac the further ability to take the dramatic step of removing an elected director from the Farmer Mac board for allegedly running afoul of the conflict of interest policy would place too much power in the hands of the other members of the Farmer Mac board.

Furthermore, automatic removal of elected directors is not appropriate where there can be disagreement about the definition of a "conflict of interest" and whether one exists in any particular circumstance. The Farmer Mac Code devotes several pages to the definitions of "conflict of interest," "material," and examples of what might constitute a conflict of interest.<sup>12</sup> Numerous changes have been made to these definitions by the Farmer Mac board in recent years. Together, this leads to uncertainty about what exact conduct is encompassed within the definition. In addition, the determination of whether a conflict of interest exists, by its nature, is a fact-intensive inquiry. Reasonable minds may differ about whether a particular conflict is one that rises to the level of materiality articulated in the Farmer Mac Code. Automatic removal is too strong a remedy where reasonable minds can disagree on the characterization of a conflict of interest, particularly given Congress' clear intent, embodied in the Farm Credit Act, that Class A and Class B directors be elected by, and represent, the interests of Class A and Class B shareholders on the Farmer Mac board.

Transferring power from Class A and Class B shareholders to the Farmer Mac board by authorizing Farmer Mac to adopt bylaw provisions for the automatic removal of an elected director found to have violated Farmer Mac's conflict of interest prohibitions should be avoided.

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<sup>9</sup> See generally 59 Fed. Reg. 9622–27 (March 1, 1994) (implementing Part 650 of the FCA regulations, later renumbered as Part 651 of the FCA regulations).

<sup>10</sup> Farmer Mac Code, Art. V.

<sup>11</sup> Id.

<sup>12</sup> Even after going into great depth on the topic, the Farmer Mac Code admits the difficulty of the determination: "[I]t is not possible to anticipate all forms of conflict of interest that may arise in a business as complex as Farmer Mac's." Farmer Mac Code, Art. II.

**(6) What, if any, additional process besides the nominating committee should there be for shareholders to add director-candidates to the ballot (e.g. floor nominations, petition)?**

The Class A and Class B shareholders have the power to elect five Class A directors and five Class B directors, respectively, to the Farmer Mac board. This right is established by Farmer Mac's statutory charter and must be acknowledged and respected by Farmer Mac's director nomination process.

Currently, the Farmer Mac bylaws require that Class A and Class B shareholders notify Farmer Mac well in advance of Farmer Mac's annual meeting of any director-candidates that they wish to nominate and elect at the meeting. This is a time-consuming and expensive process for Farmer Mac's voting shareholders. In addition, it constrains shareholders' ability to change their minds about director-candidates by prohibiting such shareholders from bringing forward new or additional candidates closer to (or at) the time of the Farmer Mac annual meeting.

The current restrictions on nomination rights found in the Farmer Mac bylaws should be replaced with provisions that permit floor nominations at the Farmer Mac annual meeting without any advance notice and/or that permit shareholders to nominate directors in advance of the annual meeting via a petition process.

One approach would be to grant Class A and Class B shareholders of Farmer Mac the right and opportunity to nominate and elect directors from the floor of Farmer Mac's annual meeting of shareholders without any advance notice thereof. Although recently abolished by Farmer Mac, this right was long held by Farmer Mac's voting shareholders. Congress' intent in the Farm Credit Act was to allow broad participation in the management of the American agricultural finance system,<sup>13</sup> of which Farmer Mac is an important part. The restrictions on the election of Class A and Class B directors (which were only recently adopted by Farmer Mac) were not authorized by Congress and run directly counter to clear Congressional intent. As noted above, the Farmer Mac board was purposely created by Congress as a constituent body, consisting of five directors elected by Class A shareholders, five directors elected by Class B shareholders and five directors appointed by the President of the United States. Floor nominations would ensure that the Class A and Class B shareholders can exercise their Congressionally granted power to elect directors of their choice.

A second approach would be to grant Class A and Class B shareholders of Farmer Mac the right to place director-nominees on the Farmer Mac ballot via a petition process. Only shareholders holding a certain minimum percentage of Class A or Class B stock, as applicable, would be permitted to petition for a director-candidate to appear on the Farmer Mac electoral ballot. The Farmer Mac board could not refuse to allow the nomination of any director-candidate for which a petition was submitted to Farmer Mac. This approach would ensure that Class A and Class B shareholders are able to vote for director-nominees of their choice, unencumbered by any restrictions devised by the incumbent Farmer Mac board.

The recent curtailment of the rights of voting shareholders of Farmer Mac set a negative precedent, taking power away from Class A and Class B voting shareholders and putting it in the hands of the full Farmer Mac board. The onerous "advance notice" requirement for director nominations appeared to be purposefully designed to entrench the incumbent Farmer Mac board, because the changes were

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<sup>13</sup> See 12 U.S.C. § 2001 (declaring that one of the Congressional objectives of the Farm Credit Act is to "encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture").

adopted by the board without shareholder, FCA or Congressional notice or approval. We believe these changes should be replaced with provisions more in line with Farmer Mac's statutory charter and public policy mission.

For the foregoing reasons, the ability of the Class A and Class B shareholders to nominate and elect directors is an essential element of the governance structure of Farmer Mac, and should be strengthened by providing for floor nominations and/or a petition process for director-nominees.

**(7) What other director nomination guidelines should be considered to preserve the representational election of Class A and B directors on the Farmer Mac board.**

The FCA's current guidance that Class A and Class B directors on the Farmer Mac board must have an "official affiliation" with the Class of shareholders that elected them that is "visible and substantial"<sup>14</sup> is sound, and should remain unchanged.

The affiliation requirement is necessary to give effect to the statutory language ensuring the representational nature of the Farmer Mac board. Farmer Mac's authorizing statute requires that an elected director representing Class A or Class B shareholders that "ceases to be such a representative" may continue on the Farmer Mac board for no longer than 45 days following "the date such member ceases to be such a representative."<sup>15</sup> FCA's "official affiliation" guidance describes what it means to be a "representative" of the Class A or Class B shareholders. Absent such guidance, it would be impossible to identify when an elected director has ceased acting as a "representative" of the Class of shareholders that elected him or her, thereby calling into doubt the proper running of the 45-day continuation period.

In addition, and for the reasons more specifically discussed above, we believe FCA should adopt regulations bolstering the ability of the Class A and Class B shareholders to nominate and elect directors via floor nominations and/or a petition process. It is essential that Class A and Class B shareholders have the ability to be represented on the Farmer Mac board by directors elected by them, and either of these approaches would further that ability in a very targeted and precise manner.

**(8) Should the FCA amend its regulations to identify certain fiduciary responsibilities associated with serving as a director of a GSE? If so, how?**

No. FCA should not amend its regulations to identify certain fiduciary responsibilities associated with serving as a director of a GSE. Fiduciary duties owed by directors to their corporations have always been, and should continue to be, fluid and evolving, based on the particular facts and circumstances of each corporation and each director. If FCA attempted to legislate a fiduciary duty standard in the form of a rigid (and difficult-to-amend) FCA regulation, it would enshrine a "one-size-fits-all" standard in a context where such a standard is not appropriate.

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<sup>14</sup> 59 Fed. Reg. at 9624 ("The FCA believes that the statutory term "representative" means that elected directors must have an official affiliation with a class A or class B institution in order to serve as a [Farmer Mac] director. The FCA views an official affiliation as a substantial and visible connection such as serving as a director, officer, or employee of a class A or class B institution.").

<sup>15</sup> See 12 U.S.C. § 2279aa-2(b)(5).

This approach would be particularly inappropriate given the unique structure of the Farmer Mac board. As a GSE with a congressionally mandated charter, Farmer Mac is differently situated than a typical corporation created under state law with a charter that can be amended by action of the corporation's board and shareholders. Neither the Farmer Mac board nor its shareholders are permitted to alter its charter; only Congress has the power to do so. Although we believe Farmer Mac directors must abide by the same general fiduciary duties as directors of privately-chartered corporations (e.g., the fiduciary duties of care and loyalty), these fiduciary duties must be exercised by Farmer Mac directors in the context of, and consistent with, Farmer Mac's statutory charter, public purpose, and special status as a GSE. In particular, directors must exercise their fiduciary duties to Farmer Mac consistent with the duties they owe to Class A or Class B institutions.<sup>16</sup> Attempting to precisely and definitively circumscribe the full extent and scope of the fiduciary duties owed by Farmer Mac directors to Farmer Mac via FCA regulation—particularly if the fiduciary duty standards mandated by FCA were lifted from standards arising in the context of privately-chartered corporations—would be an incredibly difficult, if not impossible, task.

In the context of Farmer Mac governance changes, we think the FCA's time and resources are better directed elsewhere.

**(9) How might FCA clarify existing Farmer Mac board responsibilities and authorities to improve the board's ability to carry out its fiduciary and oversight responsibilities?**

FCA can improve the Farmer Mac board's ability to carry out its fiduciary and oversight responsibilities by ensuring Farmer Mac's governing documents are consistent with the congressionally mandated structure of the Farmer Mac board. Farmer Mac directors elected to the board by the Class A or Class B shareholders must be representative of the Class of shareholders electing them. The purpose of this representative board structure is to ensure the elected directors bring the independent judgment of the Class A and Class B shareholders to the Farmer Mac board. This is a statutory requirement that cannot be altered by Farmer Mac.

FCA should ensure that Farmer Mac's governing documents do not contain provisions that unduly interfere with or impair the statutory structure envisioned, and legislated, by Congress. Recent amendments to the Farmer Mac Code and bylaws, for example, could be seen as eroding the ability of Class A and Class B directors to be representative of their electing constituencies. These amendments include provisions regarding (1) confidential information, (2) conflicts of interest, (3) director nomination and election procedures, and (4) agreements between Farmer Mac shareholders and directors. The Farmer Mac board was purposely created by Congress as a constituent body, consisting of five directors elected by, and representative of, Class A shareholders, five directors elected by, and representative of, Class B shareholders and five directors appointed by the President of the United States. Farmer Mac's authorizing statute requires that an elected director representing Class A or Class B shareholders that "ceases to be such a representative" may continue on the Farmer Mac board for no longer than 45 days following "the date such member ceases to be such a representative."<sup>17</sup> Farmer Mac's governance

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<sup>16</sup> See, e.g., 59 Fed. Reg. at 9623 ("Elected directors typically have simultaneous responsibilities to [Farmer Mac] and to a competing class A or B institution. . . . Where directors have fiduciary duties to competing institutions, they must balance these duties to avoid harming either institution.").

<sup>17</sup> See 12 U.S.C. § 2279aa-2(b)(5).



documents must recognize, and accommodate, the fact that directors elected by the Class A and Class B shareholders must be “representative” of one of these groups to continue serving as directors.

FCA should carefully review Farmer Mac’s governing documents to ensure that they are consistent with, and reflective of, the representative nature of the Farmer Mac board mandated by statute.

**(10) How might FCA facilitate maintaining a transparent representational relationship between elected directors and Class A and B stockholders while ensuring the protection of Farmer Mac’s proprietary business information?**

FCA can maintain a transparent representational relationship between elected directors and Class A and Class B shareholders while ensuring the protection of Farmer Mac’s proprietary business information by adhering as closely as possible to Congress’ intent in creating Farmer Mac, as embodied in Farmer Mac’s congressionally created statutory charter. This means recognizing that any Farmer Mac rule obligating a director to disclose to Farmer Mac material information in the director’s possession must have an express carve-out for information that is protected by confidentiality restrictions and/or fiduciary duties owed to other institutions and entities by the director in possession of such information.

We recognize and understand the need for all entities to enact policies to protect their confidential information. However, as currently drafted and in effect, the Farmer Mac Code’s provisions concerning confidential information unduly interferes with the ability of Class A and Class B directors to fulfill their fiduciary duties to Farmer Mac and its shareholders. The Farmer Mac Code requires all directors to adhere to a very strict standard of confidentiality, whereby, subject to limited exceptions, (1) “non-public” information of Farmer Mac may not be disclosed to any third party without Farmer Mac’s prior consent, and (2) any material information in the director’s possession related to any board decision must be disclosed to Farmer Mac, without regard to whether such information was protected by confidentiality restrictions or fiduciary duty obligations.<sup>18</sup> The definition of non-public or “confidential” information of Farmer Mac is, and has been, very broadly defined by Farmer Mac to include any information not found on the Farmer Mac website or filed with the U.S. Securities and Exchange Commission, even though such information might otherwise be publicly available and publicly known.<sup>19</sup>

To effectively represent his or her constituency, each director representing the Class A or Class B shareholders of Farmer Mac must be able to consult with their respective Class A or Class B institutions, as applicable. The elected directors of Farmer Mac fulfill an important role in representing their constituencies on the Farmer Mac board. Not only is the representation of the constituency that elected a director permitted, but this representation is a key function of the structure of the Farmer Mac board, since, as noted above, the board is divided into equal numbers of financial institution-elected directors, Farm Credit System-elected directors, and federally-appointed directors. This structure enables the directors elected by Farmer Mac’s Class A and Class B shareholders to represent and protect the interests of those shareholders on the board, consistent with the directors’ fiduciary duties to Farmer Mac and all of its shareholders. In order to exercise informed independent judgment, directors elected by Class A and

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<sup>18</sup> See Farmer Mac Code, Art. II (quoting from FCA’s final rule regarding a Farmer Mac conflict-of-interest policy (59 Fed Reg. at 9623), “Fiduciary duty to [Farmer Mac] requires the director to share with the Board any material information in his or her possession that is germane to Board decisions, regardless of its source.”).

<sup>19</sup> See *id.*, Art. IX.

Class B shareholders may need to discuss a whole range of matters with such shareholders. These discussions might be overly curtailed (such that directors cannot fulfill their representative role on the Farmer Mac board or their fiduciary duties to Farmer Mac and its shareholders) if such directors constantly fear inadvertently disclosing “confidential” information of Farmer Mac to a Class A or Class B institution, particularly in light of the overbroad definition of “confidential” information adopted by the Farmer Mac board. Similarly, Farmer Mac directors who learn confidential information from their electing constituency may in some cases, given the current language in the Farmer Mac Code, face the choice of keeping that information confidential and risking a violation of the Farmer Mac Code, or violating that confidentiality and breaching a duty of confidentiality or fiduciary loyalty to the electing shareholder. The result is a limitation on the Class A and Class B directors’ ability to bring an independent judgment to the Farmer Mac board, even though this is precisely what the Farmer Mac statutory charter envisions.

The FCA has long recognized the need for Class A and Class B directors to communicate with the constituencies that elected them. FCA regulations state that “directors have a duty to exercise informed independent judgment on [Farmer Mac] matters, and may from time to time need to consult with knowledgeable advisors,” provided that such consultations must be made “with due regard for [Farmer Mac’s] interest in maintaining confidentiality”.<sup>20</sup> Requiring Farmer Mac’s Class A and Class B directors to disclose all information in their possession that is germane to Farmer Mac board decision-making, without an express carve-out for information that is protected by confidentiality restrictions and/or fiduciary duty obligations owed to other institutions and entities, does not recognize the proper structure and governance of Farmer Mac as legislated by Congress. This omission should be promptly remedied.

**(11) To what extent should Farmer Mac’s risk tolerance consider its public policy purpose? How might that be measured?**

FCA should consider clear risk tolerance standards for Farmer Mac based on its true risk-bearing ability, and critical to the long-term performance of its public policy mission, especially in light of their change in goal and resulting business strategy from that which Congress intended. Critical risk tolerance measurements are capital adequacy and liquidity standards. While the Agricultural Credit Act of 1987 establishes some criteria for Farmer Mac’s capitalization, we believe that the statutory definitions are not inherently effective risk tolerance measures for use at the Farmer Mac board level. Instead, Farmer Mac should be required to measure its capital adequacy as compared to commercial banks under Basel III, including the appropriate treatment of equity securities and risk weighting of assets. The Farmer Mac board should then be required to establish a risk tolerance that is consistent with capital adequacy standards for common equity Tier 1, Tier 1, and Tier II, including applicable conservation buffers and applicable leverage ratios. In applying these standards, FCA should strongly consider prohibiting Farmer Mac from using creative interpretation around the treatment of capital securities and risk profile of assets. To be effective, the application of the Basel III standards, as implemented by U.S. banking regulators, should be unadulterated by Farmer Mac. Importantly, until such time as FCA establishes this standard and determines that Farmer Mac has achieved, and is maintaining, compliance with the standard, it should immediately prohibit Farmer Mac from implying Basel III compliance in its public disclosure statements.

From both a risk and public policy mission perspective, it is imperative that the Farmer Mac board manage Farmer Mac’s capital position in a manner consistent with other regulated financial

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<sup>20</sup> 59 Fed. Reg. at 9625.

institutions, particularly given its loan buy-and-hold business strategy. The capital standards applicable to regulated financial institutions are appropriate for Farmer Mac to avoid excessive leverage and risk taking as well as provide for financial strength to serve its public policy mission during downturns in the agricultural or financial markets. Directors should voluntarily direct Farmer Mac's management to comply with the capital standards applicable to regulated financial institutions. At a minimum, this approach would ensure a risk tolerance floor that is at least consistent with well thought-out and researched capital standards that ensure financial stability for the long-term. Moreover, it is a standard by which financial institutions are commonly measured in the financial markets, which fundamentally would enhance the transparency of Farmer Mac's risk-bearing capacity on a standalone basis. Fundamentally, Farmer Mac is already incorrectly publicly communicating as if it is complying with Basel III capital standards as demonstrated by its statement that its recent perpetual preferred stock issuance qualifies as Tier I capital. Therefore, it is a logical measurement for directors to use in establishing a risk-tolerance for Farmer Mac.

Beyond Basel III capital adequacy standards as a risk-tolerance floor, the FCA should require Farmer Mac to consider other measures relative to risk funds and average earnings. These other measures should manage risk in the loan portfolio relative to loan size, loan types, industries, and geographies. We believe the comprehensive guidance for loan portfolio management applicable to Farm Credit System institutions should be applied to Farmer Mac as a minimum requirement, particularly in managing risk concentrations. Fundamentally, the guidance is universally applicable to any financial institution. Similarly, risk tolerance standards are needed on unique or structured loan transactions with single attributed customers, including large loan balances where Farmer Mac has structured the transaction to avoid the principal limit for real estate loans established in 12 U.S.C. 2279aa-8 (Standards for Qualified Loans).

Finally, Farmer Mac's directors should consider liquidity reserve requirements that exceed regulatory minimums and that are more consistent with the Basel III liquidity reserves. We believe directors should consider a tiered approach similar to what is applicable to the Farm Credit System, including a 15-day, 30-day, 90-day, and beyond 90-day requirements. The board should also identify the cash and investments with appropriate marketability characteristics for each risk tolerance tier. This comprehensive liquidity risk tolerance should be further tested and evaluated on a regular basis, with directors requiring greater liquidity levels of highly marketable investments or cash during volatile financial or agricultural market conditions.

**(12) How might the FCA ensure that the Farmer Mac board establishes an effective risk governance framework, including risk measurements (e.g. data collection), risk controls and reporting, and clearly articulated statements of risk tolerance?**

The Agricultural Credit Act of 1987 provides FCA with broad authority to oversee and supervise the safety and soundness of Farmer Mac. As FCA does with the Farm Credit System, it can effectively ensure the board establishes a risk governance framework through supervisory guidance at Farmer Mac. As discussed in our comments to question 11 above, a key aspect of any guidance is for FCA to specifically identify acceptable risk measurements for Farmer Mac, as it has done for the Farm Credit System. Therefore, FCA should be specific on what risk tolerance measures are required going forward, such as Basel III capital adequacy standards, portfolio risk limits, concentration limits, and liquidity tolerance. Within the financial services industry, there are well-established risk governance frameworks that address risk measures, risk controls, reporting, risk appetite and tolerance statements, such as Enterprise Risk Management (“ERM”). ERM is designed to be an internal framework for managing risk that institutions implement to ensure effective risk management disciplines. ERM, however, is just one approach and there are other appropriate frameworks to accomplish effective risk governance. Regardless of the approach selected, we applaud FCA for asking this question and encourage the FCA to require the

Farmer Mac board to establish a risk governance framework going forward, which is consistent with the requirement that the Farm Credit System has adhered to for a number of years.

**(13) If FCA requires the Farmer Mac board to have a risk committee, what guidelines should FCA provide regarding the formation and duties of the committee? What qualifications should risk committee members possess? What resources should be available to the committee? Should the committee have direct access to all members of the Farmer Mac management team?**

As Farmer Mac's safety and soundness regulator, we believe that FCA is in the best position to identify what guidelines it should apply to a risk committee requirement for Farmer Mac. While we do not have a specific position with respect to such guidelines for Farmer Mac, we do know that risk committees are a common structure found at companies in the financial services industry. For instance, risk committees are often established with guidelines granting them the following authorities and/or duties:

- Periodic meetings with management and ability to hold executive sessions
- Maintenance and approval of meetings
- Authority to have direct access to and open communications with management
- Authority to request reports and information from internal and external sources
- Authority to require any company manager, consultant or auditor to meet with the committee
- Responsibility for evaluating risk management practices and providing guidance
- Review of the annual report on risk controls
- Approval of major changes to risk policies
- Review, evaluation, and approval of risk reports, risk assessments, risk mitigation strategies, etc.
- Review and recommendation of updates to the risk committee charter
- Responsibility to advise the board on risk management issues

While these points are generic in nature, they provide a good sense of the breadth of authority and responsibilities found within risk committee charters.

When determining risk committee requirements for Farmer Mac, FCA should focus on the approach and requirements found at well-managed financial institutions. The credibility of the risk committee requirements will be enhanced if they are consistent with the standards found within the industry. In all instances, Farmer Mac should be held to the same high standards seen within the industry. This would mitigate a broad perception that FCA, acting through the Office of Secondary Market Oversight, has not consistently required Farmer Mac to follow strong business and financial management practices and disciplines commonly found within the financial services industry or applied to the Farm Credit System.

FCA has often justified its position on the lack of safety and soundness requirements for Farmer Mac based on a variety of points relating to mission, statutory constraints, business stage, or securitization business model. We believe that this has led to a situation where Farmer Mac has a risk profile greater than if it were to follow the practices of a well-managed regulated financial institution. This risk profile is marked by excessive leverage, poor capital quality, poor earnings performance, excessive dividend payments, excessive executive compensation, funding risk, and liquidity risk. In total, these unregulated risks resulted in significant financial stress at Farmer Mac from inappropriate risk concentrations in its investment portfolio during the 2008 financial crisis. GSEs like Farmer Mac must remain financially strong when a financial crisis occurs in order to fulfill their public policy mission. Therefore, it is critical that FCA hold Farmer Mac to at least the same level of risk management practice, risk committee

requirements, and risk controls found at regulated financial institutions. Otherwise, the guidance will result in poorer controls at Farmer Mac than at other financial institutions and the attendant risk that such poor controls bring.

**(14) To what extent should FCA issue regulations to address difficulties Farmer Mac may have as a GSE in complying with modern governance standards because of statutory and regulatory requirements regarding the structure, selection, and composition of its board?**

To reiterate our responses to several of the foregoing requests for comment, FCA's regulations must continue to recognize the unique governance structure established by Congress when it created Farmer Mac.

To the extent FCA proposes new regulations relating to Farmer Mac's governance, those regulations must be consistent with the statutory scheme created by Congress. The Farmer Mac board, by Congressional fiat, is mandated to consist of (1) five directors elected by, and representative of, Class A shareholders; (2) five directors elected by, and representative of, Class B shareholders; and (3) five directors appointed by the President of the United States, and representative of the general public. In this way, Congress established that the Farmer Mac board would be representative of three distinct groups: (1) financial institutions other than those of the Farm Credit System (Class A shareholders); (2) financial institutions of the Farm Credit System (Class B shareholders); and (3) the U.S. government/general public. The structure is designed to ensure that Farmer Mac accomplishes its public policy mission, as a GSE, in an appropriate and focused manner.<sup>21</sup>

As the foregoing makes clear, Congress, through the Farm Credit Act, established a unique governance structure for Farmer Mac not found at other publicly traded companies. While we believe many principles applicable to directors at other publicly traded companies are also applicable to Class A and Class B directors of Farmer Mac (e.g., general fiduciary duty principles of care and loyalty), specific application of such general principles to Class A and Class B directors must take into account the unique nature of the Farmer Mac board. For example, limitations on communications and/or agreements between Class A and Class B shareholders and elected directors must not be so strict as to negate the directors' ability to be "representative" of such shareholders. In addition, Farmer Mac's confidentiality provisions must not be so strict so as to prohibit directors elected by Farmer Mac's Class A and Class B shareholders from effectively communicating with such shareholders in order to bring their views and perspective to the rest of the Farmer Mac board. More generally, the unique structure of the Farmer Mac board and fact-intensive nature of any inquiry into Farmer Mac's governance cautions against broad "one-size-fits-all" approaches, and instead requires particular attention to particularized factual scenarios.

Unfortunately, recent governance changes adopted by the Farmer Mac board, without shareholder, FCA or Congressional approval, have altered the carefully constructed balance of power embodied in Farmer Mac's congressionally-mandated charter. For example, the Farmer Mac Code and bylaws, as currently adopted and in effect, deny Class A and Class B shareholders the ability to nominate and elect director-candidates from the floor of the Farmer Mac annual meeting without advance notice of such nominations. This is a restriction on the rights of Farmer Mac's voting shareholders to elect directors "representative" of their Class, and runs directly contrary to clearly articulated congressional

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<sup>21</sup> See, e.g., 12 U.S.C. § 2001 (declaring that one of the Congressional objectives of the Farm Credit Act is to "encourage farmer- and rancher-borrowers participation in the management, control, and ownership of a permanent system of credit for agriculture").

intent. We believe these and other changes to Farmer Mac's governance in recent years were designed to accomplish just this outcome—shifting power from Class A and Class B shareholders to incumbent members of the Farmer Mac board in an effort to stifle the independent judgment and perspective brought to the board by elected directors. We hope this recent trend will be reversed as quickly as possible.

For the foregoing reasons, FCA's regulations concerning the governance of Farmer Mac, and the operation of the Farmer Mac board, must recognize the unique governance structure chosen by Congress when it created Farmer Mac, and, in particular, the imperative that directors on the Farmer Mac board be elected by, and remain representative of, Farmer Mac's Class A and Class B shareholders.

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Thank you for your consideration of our comments on these important matters. We would be pleased to discuss any of our comments with you further, at your request.

Respectfully submitted,

CoBank, ACB and CoBank, FCB

By:



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Robert B. Engel  
Chief Executive Officer

Farm Credit Bank of Texas

By:



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Larry R. Doyle  
Chief Executive Officer